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EURUSD: MORE UPSIDE AHEAD?

IS THIS THE BEGINNING OF EURUSD BULL TREND?

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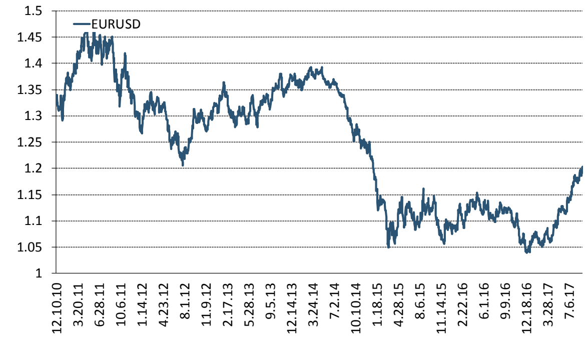
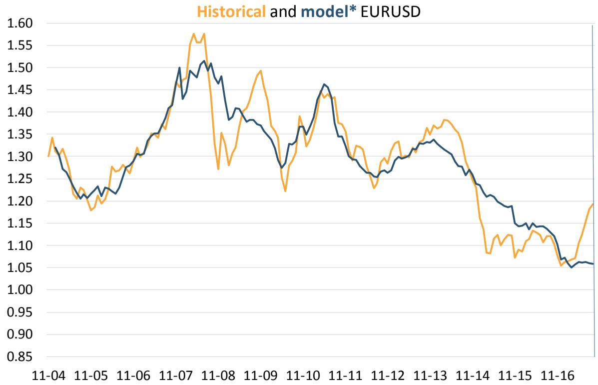
- **EURUSD recently returned to highest since the end of 2014…**
- **…raising questions whether euro is at the beginning of long ride up against the greenback.**
- **My view is that it is very unlikely in the next 12 months.**

The EURUSD exchange rate recently moved to the level I forecast for this year (1.20) and thus reached the highest since the end of 2014. This immediately raised questions over how much more can the euro rise, especially considering the plans on both shores of the Atlantic to tighten the monetary policy in one way or the other. I therefore think it is now appropriate time to look at whether this EURUSD rally - which caused some uneasiness recently at the ECB (though much smaller than what I would have expected it would) – will run further.



SOURCE: 42 FINANCIAL SERVICES

Before an answer can be given to this, we need to look at what was the major driving factor for the EURUSD exchange rate in the preceding years. The major influence here – and one that is supported by the data – is that the **EURUSD exchange rate was to a good extent determined by the monetary stance of the respective central banks**. Whenever the balance sheet of FED increased relative to that of ECB (= monetary policy in US was being relaxed at faster rate than what was the case in Europe), euro rallied, and the other way around. The divergence, which was reflected in the relative evolution of the respective central banks' balance sheets and in the interest rate differential between the Eurozone and USA, can explain the evolution of the EURUSD exchange rate over quite a long period of time. This is seen in the following picture



SOURCE: ECB, FED, CALCULATIONS: 42 FS.

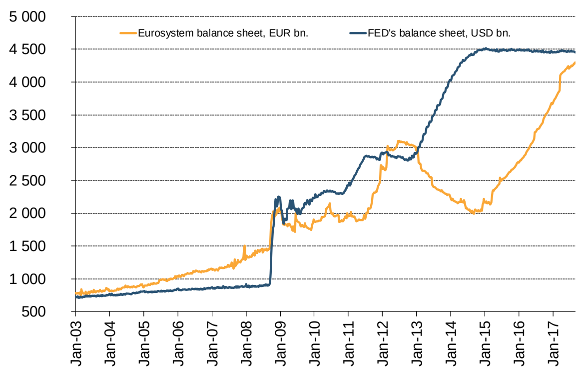
* MODEL IS BASED ON INTEREST RATE DIFFERENTIAL (SPREAD BETWEEN US AND GERMAN 2Y GOVERNMENT BOND YIELDS) AND SIZES OF BALANCE SHEETS OF FED AND OF ECB.

Obviously, and especially recently (i.e., post 2012 once the debt-crisis fears abated), **the EURUSD exchange rate did not follow but "run ahead of" the model**: the large EURUSD fall in 2014 and first quarter of 2015 (from 1.40 to below 1.10) was driven by the *expectation* of the ECB's QE and the *expectation* of tighter US policy. The former indeed materialized when ECB launched QE purchases in September 2014 and then expanded the program by including the government bonds among purchased instruments at the end of January 2015. The latter occurred when FED decided to taper its purchases back in December 2013 and when it first hiked one year thereafter. The exchange rate responded fast. As the fact that the modelled exchange rate and the actual exchange rate eventually met (i.e., that the blue and yellow lines in the picture above eventually intersected at the end of 2016) proves, the market correctly guessed the interest rate differentials and relative sizes of the ECB/FED balance-sheets that would result from these changes.

Now, the divergence between the modelled and the actual exchange rate is here again. Although the model shows that EURUSD exchange rate should fundamentally be around 1.05, it is not, having recently risen to 1.20 instead. **What is it that the market is telling us it expects?**

Clearly, it is expecting the tightening of the policy of the ECB relative to that of FED, the size of which can be determined from the relatively simplified but surprisingly accurate model. The mode has two principal components: the interest rate differential (as proxied by the difference between 2-year government bond yields in US and Germany) and the relative sizes of the balance sheets of the banks. Of course, these two are to some extent related, but not 1 for 1 (sizes of the balance sheet and changes thereof show general stance of the monetary policy).

As regards the size of the respective balance sheets, it is clear that they will not expand much or at all. FED is close to actually beginning to shrink the balance sheet soon whereas ECB is close to discontinuing the purchases that in last two years took the balance sheet of ECB to over the balance sheet of FED.



SOURCE: ECB / FED

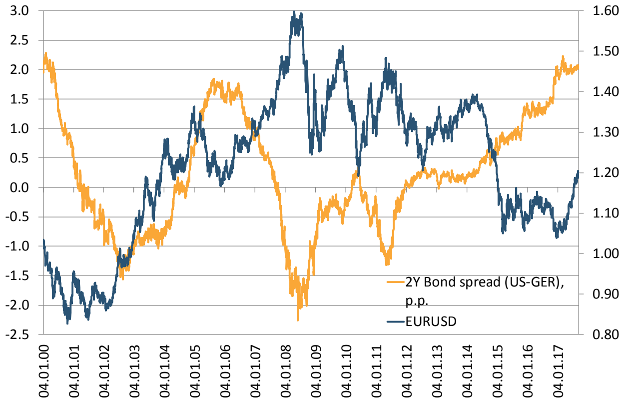
The plan for FED is as follows. The FED is planning to gradually decrease the size of its balance sheet by discontinuing the reinvestment of the principal payments it receives from securities it holds. Those principal payments will be reinvested only to the extent that they exceed gradually rising caps:

- For payments of principal that the Fed receives from maturing Treasuries, the cap is proposed to be $6 billion per month initially and to increase in steps of $6 billion at three-month intervals over 12 months until it reaches $30 billion per month.
- For payments of principal that the Fed receives from its holdings of agency debt and mortgage-backed securities, the cap is anticipated to be $4 billion per month initially and will increase in steps of $4 billion at three-month intervals over 12 months until it reaches $20 billion per month.

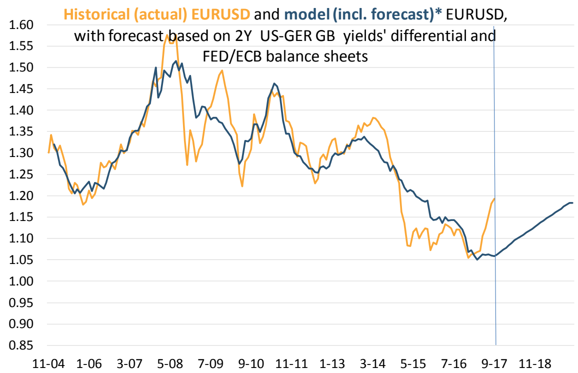
In other words, the FED holdings will be initially falling by USD 10 bn./month and this will increase to USD 50 bn./month 12 months thereafter. This means the balance sheet will shrink by approx. USD 300 bn. in first year and by USD 600 bn. in each of the following ones.

For ECB, the crucial decision is how fast will the tapering occur (that some tapering of the QE will soon be announced is clear after the last ECB meeting). I assume that the current rate of EUR 60 bn./month will gradually be reduced to zero starting in January 2018: the current program is scheduled to run until December 2017 and ECB said in September it would announce "bulk" of the decisions on the future of QE this October. **I expect the purchases to be reduced to zero by December 2018.**

The second component – the one with more weight in the simplified EURUSD model depicted above – is the interest rate differential. Here, it is safe to assume that when ECB stops the purchases and as Eurozone inflation gradually increases, the current wide spread between US and Germany will begin to narrow.



SOURCE: 42 FINANCIAL SERVICES



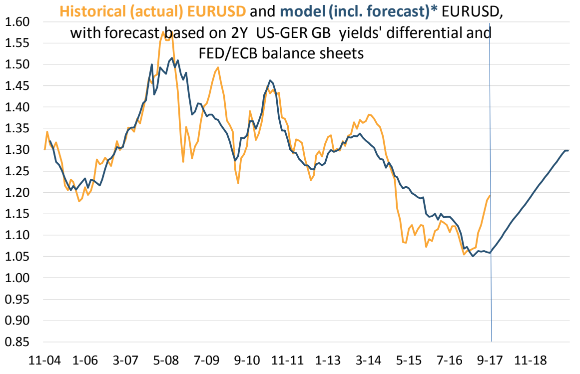
* THIS BASELINE FORECAST IS BASED ON 1) ECB TAPERING TO ZERO NET MONTHLY ASSET PURCHASES BY THE END OF 2018 AND THEREAFTER BALANCE SHEET SHRINKING NATURALLY AS ASSETS MATURE, 2) FED BALANCE SHEET SHRINKING BY USD 300 BN. IN 2018 AND USD 600 BN. IN 2019 AND, 3) US-GER 2Y GB YIELD DIFFERENTIAL FALLING TO 1 P.P. BY THE END OF 2019.

The question is by how much. Although the fact that ECB will not be buying bonds anymore means cet.par. higher yields, the evidence that Draghi managed to prepare the market for the coming tapering without causing almost any ripples (bonds didn't experience any taper tantrum like their US counterparts did back in 2013 after Bernanke May 2013 speech ↗) and the expectation that inflation will rise only very slowly, thereby keeping ECB rates unchanged well into 2019, **means there will probably not be any big increase of the yields**. On the other hand, FED, although confronted with much lower inflation than it'd hitherto forecast, will continue to tighten, if only at the slow rate (50 bps. in hikes per year). Although unlikely, there may be outright sales from the FED's portfolio of Treasuries down the road. **This to me means that the US-GER 2Y spread will fall, but also that it will remain sizeable, i.e. at around 1 pp. over next two years.** I therefore assume that the current spread of little over 2 pp shrinks to 1 pp by the end of the 2019.

Putting these assumptions together yields the following EURUSD baseline forecast.

In words, this means that **current EURUSD exchange rate is consistent with fairly aggressive reduction of the FED's balance sheet, ECB tapering to zero over 2018 and US-GER bond spread halving from the current levels, all happening over 2018-2019**. In other words, EURUSD market is again ahead of itself and prices in quite significant changes in the monetary policy of FED and ECB over next 2 years. **Therefore, I don't see much space for further weakening of the dollar vis-à-vis the euro**.

Even the return of bond spread to 0 bps., which would require either reversal of the monetary policy in US (i.e., recession) or quick ECB hikes (i.e., in 2018 already), would only produce the EURUSD at 1.30, as the following picture shows. All other scenarios that are less aggressive than the baseline scenario described above (i.e., scenarios where FED's balance sheet shrinks at a slower rate, ECB tapers at slower rate, US-GER spread remains wider for longer or some combination thereof) result in EURUSD below or well below 1.20.



* THIS ALTERNATIVE FORECAST IS BASED ON 1) ECB TAPERING TO ZERO NET MONTHLY ASSET PURCHASES BY THE END OF 2018 AND THEREAFTER BALANCE SHEET SHRINKING NATURALLY AS ASSETS MATURE, 2) FED BALANCE SHEET SHRINKING BY USD 300 BN. IN 2018 AND USD 600 BN. IN 2019 AND, 3) US-GER 2Y GB YIELD DIFFERENTIAL FALLING TO 0 P.P. BY THE END OF 2019.

Considering furthermore that ECB would very likely object to more euro strength**, my conclusion is that to see EURUSD substantially higher than 1.20 in next year is far, far less probable than seeing it below that level. I see 1.20 as more or less an EURUSD upper bound for next 9-12 months.**

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